In the loop

January 2021

To GAAP or to non-GAAP COVID-19: What you should know

What you need to know

- Non-GAAP measures are being used more than ever; nearly all of the S&P 500 report at least one
- Non-GAAP measures continue to be an area of focus and frequent comment from the SEC
- Knowing the rules will help management steer clear of common areas of comment
- Companies should pay particular attention in SEC filings when reporting the impact of the COVID-19 pandemic in non-GAAP measures

Non-GAAP measures are more popular than ever

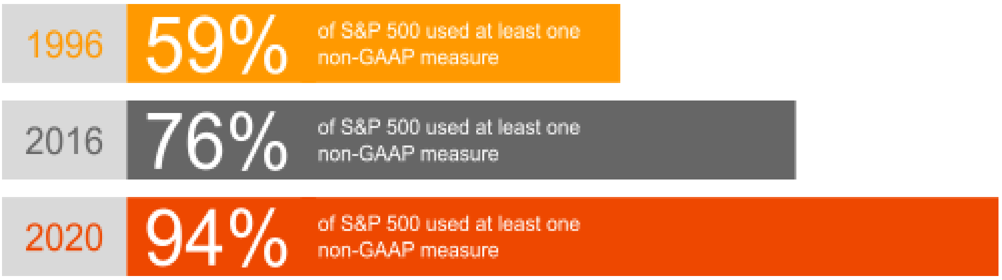
Companies use non-GAAP measures as a supplement to their financial statements to tell their stories. Some companies use them to show investors management's view of their core operations, typically by eliminating nonrecurring charges and other amounts they believe are not indicative of their ongoing performance, such as major strategic restructurings.

A measure becomes a non-GAAP measure and is subject to the SEC's non-GAAP rules and interpretive guidance when it excludes amounts that are included in (or includes amounts that are excluded from) the most directly comparable GAAP measure. Operating or other statistical measures (for example, unit sales, number of employees, and number of subscribers), certain ratios,[1] and financial information that does not provide numerical measures that are different from the comparable GAAP measures (for example, the amount of debt repayments planned but not yet made) are not subject to the non-GAAP guidance.

Some common non-GAAP measures are:

- EBIT - earnings before interest and taxes
- EBITDA - earnings before interest, taxes, depreciation, and amortization
- Adjusted earnings or adjusted EBITDA - removes various one-time, irregular, or nonrecurring items from earnings or EBITDA
- Free cash flow - typically calculated as cash flows from operating activities less capital expenditures

The use of non-GAAP measures is increasing exponentially. The average number of non-GAAP measures reported by public companies has increased from 2.5 to 7.5[2] over two decades.



[1] Those calculated using exclusively (1) GAAP financial measures, and/or (2) operating measures that are not non-GAAP financial measures

[2] Audit Analytics

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We encourage audit committees to be actively engaged in the review and presentation of non-GAAP measures and metrics to understand how management uses them to evaluate performance, whether they are consistently prepared and presented from period to period and the company's related policies and disclosure controls and procedures.

- Jay Clayton, then SEC Chairman, Sagar Teotia, SEC Chief Accountant, William Hinman, then Director, SEC Division of Corporation Finance

  December 2019 Joint statement on Role of Audit Committees in Financial Reporting and Key Reminders Regarding Oversight Responsibilities

This year, companies may be looking to present non-GAAP measures that eliminate the infrequent or unusual accounting impacts of the COVID-19 pandemic. So companies should be aware that the significant increase in the use of non-GAAP measures, even before the pandemic, has brought heightened scrutiny from the SEC staff related to how non-GAAP measures are calculated and the transparency of the related disclosures.

SEC guidance for non-GAAP measures

Registrants that are considering presenting non-GAAP measures should be aware of the SEC's rules in Regulation G and Regulation S-K Item 10(e) and the SEC staff Compliance and Disclosure Interpretations on non-GAAP measures.

Regulations

The requirements differ depending on where a non-GAAP measure is disclosed.

	SEC filings (e.g., Forms 10-K or 10-Q)	Earnings release	Any public disclosure (e.g., company's website, analyst presentation)
Applicable rule	Reg S-K, Item 10(e)	Reg S-K, Item 10(e)(1)(i)	Reg G
1. The non-GAAP measure taken together with the accompanying information cannot be misleading	✔	✔	✔
2. The most directly comparable GAAP measure must be disclosed	✔	✔	✔
3. A reconciliation of the non-GAAP measure to the most directly comparable GAAP measure must be included	✔	✔	✔
4. The GAAP measure must be presented with equal or greater prominence than the non-GAAP measure	✔	✔	
5. Management must disclose why it believes the non-GAAP measure is useful to investors	✔	✔	
6. If material, management must disclose the additional purposes, if any, for which it uses the non-GAAP measure	✔	✔	
7. Charges or liabilities that require cash settlement cannot be excluded from any measure of liquidity	✔		
8. A measure cannot be labeled as nonrecurring or infrequent (or any similar title) if it excludes amounts resulting from an event that has occurred in the last two years or is expected to occur again in the next two years	✔		
9. Non-GAAP measures cannot be presented on the face of the financial statements or in the notes	✔		
10. Non-GAAP measures cannot be presented on the face of any pro-forma financial information	✔		
11. Non-GAAP measures must not use titles or descriptions that are the same as, or confusingly similar to, GAAP titles	✔		

Foreign Private Issuers

Foreign Private Issuers (FPIs) are generally subject to the same non-GAAP measure requirements in SEC filings as domestic issuers. However, FPIs meeting all of the following criteria are exempt from Regulation G:

- The securities of the FPI are listed or quoted on an exchange outside the US
- The non-GAAP financial measure is not derived from a measure calculated and presented in accordance with US GAAP
- The disclosure is made by the FPI outside the US

Additionally, an FPI using a non-GAAP measure in Form 20-F or a registration statement is exempt from the prohibitions in Regulation S-K 10 (e)(1)(ii) (requirements 7 through 11 in the table on page 2) if the measure is (1) required or expressly permitted by the local GAAP principles used in the FPI's primary financial statements and (2) included in the FPI's annual report or financial statements.

Compliance and disclosure interpretations

The SEC staff provides certain Compliance and Disclosure Interpretations (C&DIs) of the rules and regulations for non-GAAP financial measures. Among other things, these C&DIs state that a non-GAAP measure can be misleading if it is presented inconsistently between periods or if it excludes charges but does not exclude gains. They also clarify that individually tailored accounting principles (such as adjusting a non-GAAP measure to accelerate revenue recognition that would otherwise be recognized over time) are not permitted.

Internal control considerations

Companies should be aware of the control requirements specific to different information within their SEC filings. For example, internal controls over financial reporting are required over the financial statements, including GAAP measures. Disclosure controls and procedures apply more broadly to other information, including non-GAAP measures, outside the financial statements in 1934 Exchange Act filings, such as Forms 10-K and 10-Q.

SEC comments

Non-GAAP measures have long been in the top 10 areas of comments made by the SEC staff. The most common areas of comment related to non-GAAP measures include:

1	GAAP measure is not given enough prominence
2	Reconciliation between GAAP and non-GAAP measure is missing or does not start with the GAAP measure
3	Adjustments to eliminate or smooth items identified as nonrecurring, infrequent, or unusual are not appropriate
4	Non-GAAP measure is based on an individually-tailored accounting principle (a company cannot make up its own GAAP)
5	Management's explanation of why a non-GAAP measure is useful to investors is inconclusive

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We've seen a range of non-gaap disclosures that mention COVID-19...some are fine and some start to push the envelope. One of the general principles we have when we look at non-GAAP disclosures is ‘Is this something that the company actually uses to manage itself?’...or ‘Is this something that is intended more or less to put a rosier picture on quarter-end?’ Obviously the latter is of concern.

- William Hinman, then Director, SEC Division of Corporation Finance, October 2020 interview with Center for Audit Quality

COVID-19 and the impact on non-GAAP measures

Due to the COVID-19 pandemic, more companies may be considering non-GAAP adjustments. Although non-GAAP reporting rules have not changed, in March 2020, the staff of the SEC’s Division of Corporation Finance issued reminders regarding non-GAAP financial measures in CF Disclosure Guidance: Topic No. 9 (Coronavirus (Covid-19)).

Companies are now faced with recording and disclosing infrequent or unusual gains or charges as a direct result of the pandemic. So how should a company identify the adjustments that are attributable to COVID-19? As with other non-GAAP adjustments, this identification will require judgment based on the facts and circumstances.

Some questions to consider when evaluating non-GAAP adjustments that may relate to COVID-19 include:

Attributable	Incremental	Actual	Quantifiable
- Is the adjustment directly attributable to COVID-19? - Would the item have been incurred absent COVID-19? - Is it expected to continue after the pandemic is over?	- Is the amount incremental to normal operations?	- Is the adjustment based on actual amounts (versus hypothetical costs or lost opportunities)? The SEC staff has stated[3] it does not believe it is appropriate to present a non-GAAP measure that adjusts for lost revenue.	- Is the adjustment sufficiently defined to allow reasonable quantification?

While non-GAAP measures may help management tell its story about the impact of COVID-19 on the financial statements, such measures, on their own, might not be sufficient to describe the totality of the effect of the pandemic on the business. Companies should also address such matters in their MD&A. As with any non-GAAP measure, a company that decides to present non-GAAP measures that include adjustments relating to COVID-19 should:

- provide robust disclosure relating to the adjustments attributable to COVID-19,
- ensure the controls and procedures surrounding the presentation of COVID-19-related non-GAAP measures include appropriate governance practices and policies,
- present the non-GAAP information consistently between periods,
- consider presenting the gross amount of adjustments separate from the tax effects, and
- highlight why management finds the measure or metric useful and how it helps investors assess the impact of COVID-19 on the company.

[3] Patrick Gilmore, Deputy Chief Accountant, SEC Division of Corporation Finance, December 2020 AICPA Conference on Current SEC and PCAOB Developments

COVID-19 comments

The SEC staff has begun to issue comments related to COVID-19 disclosures; however, clear trends related to non-GAAP measures have not yet developed. The comments thus far have focused on company-specific disclosures of pandemic-related risk factors and the discussion of known trends and uncertainties in MD&A, including expectations of the impact on operating results and near- and long-term financial condition, with references to CF Disclosure Guidance: Topic No. 9 for guidance.

Final thoughts

Non-GAAP measures can be an important part of the financial reporting process. Management should critically evaluate which non-GAAP measures it chooses to present by assessing the relevance for investors and other financial statement users, considering common measures used in its industry. This year, companies should pay particular attention to COVID-19-related adjustments.

Finally, governance of the preparation and disclosure of non-GAAP measures is key. Management should review its non-GAAP measures with its board of directors and audit committee, as independent board involvement may enhance the overall quality and decision-usefulness of non-GAAP measures.

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